



JENNIFER M. GRANHOLM  
GOVERNOR

STATE OF MICHIGAN  
UNEMPLOYMENT INSURANCE AGENCY  
DEPARTMENT OF LABOR & ECONOMIC GROWTH  
DAVID C. HOLLISTER, DIRECTOR  
DAVID A. PLawecki, DEPUTY DIRECTOR

SHARON M. BOMMARITO  
DIRECTOR  
UNEMPLOYMENT  
INSURANCE AGENCY

# Memorandum

**DATE:** February 28, 2005

**TO:** Members of the Employment Relations, Training, & Safety Committee

**FROM:** David Plawecki  
DLEG Deputy Director

**SUBJECT: URGENT ACTION – SUTA DUMPING**

Michigan's unemployment insurance (UI) system is a true insurance system. It builds cash reserves to pay unemployment benefits to eligible unemployed workers. Through its experience-rated tax structure, employers repay those reserves through unemployment taxes.

SUTA (state unemployment tax act) dumping is nothing more than some employers cheating on their unemployment taxes to avoid paying the taxes they owe based on their own experience (past use of those reserves).

## How big is the problem?

- In 2004, we estimate Michigan's UI trust fund lost between \$62 and \$95 million to SUTA dumpers.
- One of the issues, continually raised by those attempting to block the closing of loopholes in Michigan's UI law or make it more difficult to enforce the law, is to prove there is a problem.
  - At hearings of the Senate Commerce and Labor Committee, the Unemployment Insurance Agency (UIA) clearly reported numbers that support the estimated trust fund loss.
  - Since investigations of potential SUTA dumping began in earnest in September 2004, UIA has 63 cases under investigation, involving approximately 630 employers.
  - Thirty of these cases are far enough along for us to estimate that they alone represent \$25 million in losses to the trust fund.
  - Recently, UIA publicly announced its first major completed SUTA dumping case in which \$2.4 million was recovered for the trust fund.

## What action is needed?

Several flaws remain in the proposed legislation reported out by the Senate committee. While the department offered to provide a legislative alternative to stop SUTA dumping, the Commerce

and Labor Committee chose to ignore this solution and not even close all known schemes discovered to date. The largest of these involve Professional Employer Organizations (PEO). They are at least 40 percent of the problem in Michigan, as testimony before the committee revealed.

- At the very least, the House should act to close this known problem.
- Some PEOs use their unique dual employer status to *game* the unemployment tax system. DLEG's proposed amendment would close this loophole.
- Most PEOs are ethical and pay their fair share of taxes. They have nothing to fear by this amendment.

**Passage of the legislation as reported out of the Senate will not solve Michigan's SUTA dumping problem and will allow known tax cheating and scheming to continue.**

We urge you to protect the 98 percent of Michigan's employers who are ethically paying their fair share of state unemployment taxes.

- Protect employers from having to pick up the tax burden that tax cheaters and schemers are avoiding.
- Protect Michigan's experience-rated UI tax system. We have one of the best in the nation.
- Protect Michigan's UI system and ensure that money is there for appropriate worker benefits.

For your information, two fact sheets about SUTA dumping are attached. Please review these fact sheets.

# SUTA Dumping

## Manipulating unemployment tax rates to pay less in taxes

### UNEMPLOYMENT INSURANCE AGENCY

JENNIFER M. GRANHOLM, Governor  
State of Michigan

DAVID C. COLLISTER, Director  
Department of Labor &  
Economic Growth

DAVID A. PLATWECK, Deputy Director  
Department of Labor &  
Economic Growth

SHARON M. BOMMARITO, Director  
Unemployment Insurance Agency

#### What is SUTA dumping?

SUTA (state unemployment tax act) dumping is a tax evasion scheme involving the manipulation of an employer's unemployment insurance (UI) tax rate to achieve a lower rate, and thereby pay less UI taxes. Typically, SUTA dumping occurs when a business transfers payroll out of an existing company or organization to a new or different organization solely or primarily to reduce UI taxes.

#### How can the UI tax rate be manipulated?

There are three ways that are commonly used to manipulate the tax rate. They are:

- **Vertical method** – Create a “new” employer that is assigned a “new” employer tax rate of 2.7%, and then transfer payroll to the new employer.
- **Horizontal method** – Transfer payroll to a subsidiary with a lower UI tax rate.
- **Acquired rate method** – Find another employer with a low UI tax rate and arrange to transfer payroll to that employer.

#### What is the harm in SUTA dumping?

There are several ways in which SUTA dumping harms employers and the state's UI trust fund.

- SUTA dumping goes against the fundamental tenet of an experience-rated tax system that is widely supported by the employer community. The UI tax rate is based on an employer's history of benefit charges. With SUTA dumping, an employer with a high UI tax rate attempts to hide behind a different company with a lower tax rate and dump their UI costs on all other employers.
- SUTA dumping creates a competitive cost advantage for employers practicing UI tax evasion.
- SUTA dumping reduces money in Michigan's UI trust fund, causing an increase in unemployment tax rates for all employers. Losses to Michigan's trust fund, because of SUTA dumping, range between \$62 and \$95 million this year, and the amount is growing.
- SUTA dumping has already affected Michigan employers by reducing the tax dollars going into the UI trust fund. As a result, the state was unable to grant employers a 10% across-the-board cut in UI taxes because the trust fund failed to meet the required threshold level.
- SUTA dumping reduces funds available to pay unemployment benefits to unemployed workers.
- SUTA dumping puts those employers at a disadvantage who try to manage their work and maintain steady employment for their employees.
- SUTA dumping rewards employers for dumping their UI responsibility for past benefit charges on the rest of employers.

Although only a small percentage of employers are involved in SUTA dumping, all employers are impacted because the “escaped responsibility for benefits paid” ends up with the rest of Michigan's employers.

### What is the penalty for engaging in SUTA dumping?

If you participate in a SUTA dumping scheme and are discovered, you run the risk of paying a penalty that would amount to **four times any savings** you would have received by manipulating your tax rate.

### What should you do if you believe you may be SUTA dumping?

If you have or think you have been taken in by someone's tax advice, consider calling the Unemployment Insurance Agency's (UIA) Employer Customer Relations hotline at **1-800-638-3994**. If you *voluntarily* request an audit determination, any penalties you may be assessed for SUTA dumping could be substantially reduced.

Many businesses become involved with SUTA dumping because of a suggestion or recommendation from an accountant or consultant. This unethical and, many times, illegal advice is usually disguised with terms like "tax management" or "tax avoidance."

### What is Michigan doing to combat SUTA dumping?

#### Legislation

- With input from the business community, Michigan is drafting legislation to close any loopholes in the state's UI tax laws and establish clear guidelines about SUTA dumping for everyone to follow.

#### Detection

- In early 2005, Michigan will be adopting software developed by the U.S. Department of Labor to detect SUTA dumping. UIA is also working on other screening methods. A referral list of those possibly engaged in SUTA dumping has been started, and a team has been assembled to pursue those engaged in the practice.

#### Education

- Michigan is implementing an information program to educate employers about the harm of SUTA dumping, the law prohibiting it and the statutory penalties.

#### Enforcement

- UIA has assembled a team in its Tax Office to build cases against those engaged in SUTA dumping and to pursue civil, administrative and, if necessary, criminal penalties.

### SUTA dumping is a national problem

Michigan is not alone in its efforts to combat SUTA dumping. Other states are also involved in their own efforts to fight the problem. Recent federal legislation requires that all states take action to close loopholes in their laws that allow SUTA dumping to occur.

### For more information about SUTA dumping

To learn more about the issue of SUTA dumping, visit UIA's website at [www.michigan.gov/uia](http://www.michigan.gov/uia).



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## SUTA Dumping

- The Unemployment Insurance Agency (UIA) has projected between \$62 to \$95 million in tax losses to the trust fund due to SUTA dumping.
  - (1) the \$62 million estimate is derived from the experience of North Carolina when adjusted for the relative number of employers in Michigan; and
  - (2) the \$95 million estimate is based upon Michigan's unemployment benefit charges and their expected impact on employer tax rates.
- UIA currently has 63 cases under investigation for possible SUTA dumping. They involve approximately 630 employers.
- Based upon investigations on the first 30 cases to date, UIA has identified approximately \$25 million in tax losses.
- UIA found in its review of employer payroll transfers that approximately 60% of the 630 employers under investigation are Professional Employer Organizations (PEO).

### **The following are two examples of SUTA dumping cases in Michigan:**

(1) Company A has over the past 11 years created 47 individual "shell" companies. The new companies received the new employer tax rate of 2.7%, rather than retaining a higher tax rate based on their actual unemployment experience, which could have been as high as 10.3%.

Only one of the 47 companies reports assets or has "normal" business expenses such as rent, utilities and office supplies. The other 46 companies have only payroll related expenses, such as payroll taxes and insurance coverage.

As a result of SUTA dumping, tax losses of \$4.3 million have been identified, which when added to penalties and interest the total amount due reaches approximately \$20 million.

(2) Company B created one new corporation and transferred payroll from eight existing companies to the new corporation. The result was a significant tax loss to the unemployment trust fund. Through its investigation, UIA recovered \$2.4 million in unpaid taxes.

